FEDERAL HOME LOAN BANK
of SAN FRANCISCO

Dean Schultz
President and Chief Executive Officer

February 6, 2003

Elaine L. Baker, Secretary to the Board
Federal Housing Finance Board
1777 F Street, NW
Washington, DC 20006

Dear Ms. Baker:

The Federal Home Loan Bank of San Francisco appreciates the opportunity to respond to the Finance Board's December 20, 2002, resolution requesting comments from the Federal Home Loan Banks regarding changes in the financial services industry.

Specifically, the Finance Board's resolution requests comments from the FHLBanks "identifying their specific concerns, if any, arising from the ongoing changes in the financial services industry comprising the Federal Home Loan Bank system membership and suggesting appropriate supervisory or regulatory responses from the Federal Housing Finance Board."[1]

There is no doubt that there have been substantial changes in the financial services industry comprising the membership of the FHLBanks since the System was created in 1932. Two of the changes noted in the Finance Board's resolution are interstate branch banking and industry consolidation. These changes, which have led to the advent of regional and nationwide thrifts and banks doing business in more than one state and more than one FHLBank district, are the changes generally cited as creating the need for multidistrict membership. They are even cited, in some cases, as making multidistrict membership inevitable.

The Bank continues to believe strongly that interstate branching and consolidation in the financial services industry do not require or even support the conclusion that financial institutions with multistate and multidistrict operations must be allowed to join more than one FHLBank. The FHLBank System has continued to effectively support the nation's financial institutions in the years since nationwide branching and

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[1] Although the resolution is broad enough to cover topics other than multidistrict membership, based on Chairman Korsmo's remarks accompanying the resolution and other information released by the Finance Board, the Bank understands that the Finance Board is specifically requesting information relating to that topic and has limited its response accordingly.

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lending became commonplace. This dramatic success story serves as conclusive evidence that the System as it was originally established is perfectly well-suited to adapt to these changes under the original single membership rule.

The System has responded so effectively to these changes for the simple reason that the FHLBanks were designed from their inception to expand and contract according to the needs of their members. This simple truth applies whether the member in question is operating in a single small town on a seasonal grow-and-shrink cycle or operating nationwide with ever-expanding needs based on successive mergers and acquisitions. The concept worked under the FHLBanks' original capital structure, and it can work as well under the new capital rules approved by the Finance Board.

Thus interstate branching and industry consolidation do not require the Finance Board to respond by changing the membership rules. This is true despite changes in the distribution of members and membership assets and related changes in the distribution of capital and advance business among the FHLBanks, cited in the Finance Board's resolution. As we stated in a prior submission to the Finance Board (introduced below as **Exhibit A**), no FHLBank has ever been assured that its membership or assets will be maintained at a given level, and there is no reason for the Finance Board to seek to provide this assurance now by changing the membership rules.

Another change in the financial services industry that has been propounded in support of multidistrict membership is the increasing concentration of FHLBank assets in the largest System members, cited as a "problem" that should be corrected by dividing the credit and collateral exposure to the largest members among multiple FHLBanks. As we have said before, we do not agree (and have seen no credible evidence) that member concentration is necessarily a problem to be solved, given the way the individual FHLBanks' credit and collateral programs can be (and should be) structured under the FHLBank Act and the safety and soundness regulations of the Finance Board, properly administered under the examination and supervision of the Finance Board. As we have also asserted, even if it could be established that the concentration of assets in a few large members should be considered a problem, the Finance Board and the FHLBanks already have all the tools they need to respond without simply attempting to spread the problem across the balance sheets of more than one FHLBank.

To summarize, we strongly believe that the FHLBanks have effectively responded to the changes in the financial services industry that fall under the headings of (i) industry consolidation, (ii) the advent of regional and national institutions operating across

FHLBank district lines, and (iii) the concentration of assets in a few large FHLBank members, without the need for any change in the membership rules that have applied since the System was created. No one has provided real evidence to the contrary, or suggested any other concerns arising from changes in the membership of the FHLBanks that should lead the Finance Board to change those rules. We therefore reiterate our view, in response to the specific request in the Finance Board's resolution dated December 20, 2002, that the Finance Board should not view multidistrict membership as a necessary or appropriate supervisory or regulatory response to the evolution of the financial services industry.

Previous Submissions from the Bank to the Finance Board

On February 23, 2001, the Bank submitted a Request to Intervene in the Finance Board's consideration of a multidistrict membership petition from the FHLBank of Dallas that was based on an interpretation of Section 4(b) of the Bank Act (**Exhibit A**).[2] In the Request to Intervene, we asserted our views that (i) there is significant doubt whether Section 4(b) permits the Finance Board to allow a member of one FHLBank to become a member of another FHLBank under any conditions; and (ii) even if Section 4(b) gives the Finance Board that authority under certain conditions using a "demanded by convenience" standard, the application under consideration at the FHLBank of Dallas did not meet the requisite standard.

In the Request to Intervene, we asked the Finance Board not to consider that application or any other application in a case-by-case determination, but instead to address all of the issues relating to multidistrict membership in a comprehensive rulemaking applicable to the entire System. We understand that is the Finance Board's intention at this time, and we continue to urge the Finance Board to follow this course.

We also asked the Finance Board, if it intended to allow some form of multidistrict membership, not to move forward without first issuing regulations and guidelines addressing in advance the policy and operational issues that might be encountered by the FHLBanks in dealing with multidistrict membership. We reiterate this request, as well. At a minimum, these issues will include intercreditor issues; collateral issues; stock purchase and maintenance allocation issues; AHP competition issues; voting and director representation issues; antitrust issues; information sharing, tracking and

[2] The petition from the FHLBank of Dallas was subsequently withdrawn, and the Bank withdrew its Request to Intervene by letter dated February 5, 2002. The Bank is not reactivating the Request to Intervene, but is resubmitting only the discussion and analysis included in the letter.

reporting issues; safety and soundness issues; and other issues identified by the Finance Board, the FHLBanks, the members, and others.

On March 4, 2002, the Bank submitted a comment letter in response to a Finance Board solicitation of comments on the implications of multidistrict membership for the FHLBank System (**Exhibit B**). In that letter, in addition to the points above, we stated our view that if the Finance Board was determined to approve multidistrict membership in some form, it should only do so in a way that would control dangerous forms of competition among the FHLBanks, which will continue to jointly issue debt and share joint and several liability.

As noted in our earlier letter, "[c]ompetition is a good thing in a model that is designed to have the checks and balances inherent in a market system" - but these concepts do not describe the FHLBank System. Competition would not occur in pricing past a certain point, because the FHLBanks can employ the same funding strategies and raise funds at substantially the same cost. Competition would then have to occur in credit and collateral standards and procedures. An FHLBank that lowers its standards would win more multidistrict members, but would increase risks for the System - that is, for the FHLBanks that didn't lower their standards, but yet remained jointly and severally liable for the risk-takers' debts.

In the March 2002 letter we also reiterated our concerns about some of the significant problems that would result if the Finance Board went forward with any form of multidistrict membership, noting in particular the doubts raised earlier about the statutory authority of the Finance Board to approve multidistrict membership and the myriad of operational issues that would be presented. We also provided detailed responses to the Finance Board's specific questions about the implications of multidistrict membership, and we reiterate those points, as well.

Finally, on December 16, 2002, in conjunction with the FHLBank of New York, we submitted a letter describing a multidistrict advances participations structure that had been proposed early last year as one possible response to some of the consolidation and concentration issues identified in the multidistrict debate (**Exhibit C**). In that letter, we said that although the proposal is complex, it provides a direct solution to many of the issues under review, and we continue to urge the Finance Board to consider it carefully as one of the available options.

Summary of Key Points

In response to the Finance Board's current request for comments, in addition to resubmitting our previous communications to the Finance Board on multidistrict membership and making the points noted above, we reiterate the following key points that we have made before:

- The proponents of multidistrict membership have not made a sufficient case justifying the dramatic changes they are seeking for the System, nor have they submitted a model of how multidistrict membership would work.

- The FHLBanks are intended to expand and contract with member borrowing needs, so that changes in those needs are addressed by design and do not require a response from the Finance Board as dramatic as the proposal to allow multidistrict membership. The dramatic growth and success of the FHLBanks as a resource for their members proves this point.

- To the extent that the needs of the System's members have changed in other ways that do require a response from the Finance Board, the Finance Board and the FHLBanks have sufficient tools to effectively respond to those changes without radically restructuring the System's membership rules.

- We have seen no indication that the Finance Board can establish the necessary link between multidistrict membership and the safety and soundness of the FHLBanks. But even if the needs of the System's members have changed in a way that can only be addressed with some form of multidistrict membership, the Finance Board's authority to allow multidistrict membership under the current statute is far from clear and the risk of destabilizing uncertainty in this regard is too great to ignore.[3]

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[3] When the Finance Board adopted its recent resolution seeking comments on the multidistrict membership issues, Chairman Korsmo announced that he had received a legal opinion from the firm of Morrison & Foerster LLP making the argument that the Finance Board "not only has the authority, but indeed the affirmative obligation to address districts [*sic*] membership questions if by doing so the safety and soundness of the Federal Home Loan Bank System is enhanced or if by failing to do so the safety and soundness of the Federal Home Loan Bank System is jeopardized." We find it surprising that in considering its options in the debate on multidistrict membership, the Finance Board would find sufficient comfort in an opinion that makes clear "the matter is not free from doubt" and only manages to conclude that "there is a reasonable argument" that a Finance Board regulation authorizing multidistrict membership would be entitled to judicial deference.

- If despite the lack of real justification, the lack of clear statutory authority, and the likelihood that significant complications will result, the Finance Board opts to go forward with some form of multidistrict membership, the Finance Board should not act until it has first issued regulations and guidelines (i) addressing in advance the operational and policy issues that will be encountered by the FHLBanks in dealing with multidistrict members, and (ii) controlling the potential for dangerous forms of competition among the FHLBanks.

We look forward to working with the Finance Board as it continues to consider the important issues relating to multidistrict membership.

Very truly yours,

Dean Schultz
President and Chief Executive Officer

cc: Members of the Board of Directors